Welcome to the final edition of Institutional Insights for 2013. Naturally given the time of year, the editorial for this edition is being written with Jingle Bells playing in the background thankfully erasing the memories of a weekend pre-Christmas shopping expedition to Oxford Street.

In this edition, Katy Kaminski draws inspiration from this year’s winners of the Nobel Prize for Economic Sciences announced in October this year. The prize was awarded to Eugene Fama, Lars Peter Hansen and Robert Shiller for their work in understanding asset prices and attitudes to risk. Katy’s article draws from the work of these very distinguished economists to explain the premise behind convergent and divergent risk taking and the impact this theory could have on investment strategies taking into account black swans and market distress.

I’m delighted to welcome to this edition Margie Lindsay, Executive Editor of Hedge Funds Review. As we approach the end of 2013, it seems appropriate to hear from one of the most respected editors in the Hedge Fund arena. Margie provides us with an insightful and frank...
assessment of the shape of the hedge fund industry based on her years of in-depth discussions with the actors in this area. Topics such as the changing model of hedge funds vis-a-vis sell side banks, the changing institutional investor base as well as the outlook for emerging managers will prove to be interesting reading. In addition, Margie is Executive Producer of the new reality webTV show Hedge Fund Lions’ Den. But more on that later.

In Trading Insight, Renaud Huck moves away from futures to look at the options space, namely, Options on Euro-OAT Futures and RDX® USD Index Options (Russian Depository Index). Following the success of the existing long-term Euro-OAT Futures (with open interest of nearly 180,000 contracts), Renaud highlights the benefits of exposure to the French interest rate yield curve.

Default of a Clearing Member is one of the most widely discussed concerns of the buy side. Namely, what actually happens should the Clearing Member of a buy side firm default and what is the role of the central counterparty in this situation? For “Clearing Insight”, Renaud has provided for you an excellent summary of this and addresses the areas that buy side firms should consider and question – especially with regards to capital and collateral protection.

Now a question for you dear reader: What do you get when you combine television’s Dragon’s Den and The Apprentice with the world of hedge funds? It gives me great pleasure to welcome you to Hedge Fund Lions’ Den where reality TV meets the hedge fund world.

This world-first programme pits three emerging hedge fund managers against three legends (Lions) of the hedge fund community, namely, Lord Stanley Fink, Luke Ellis and Andrew McCaffery. The emerging managers’ ultimate goal is to win the minds of our Lions and secure investment.

This is a new and very exciting television concept that opens a new chapter in education and entertainment with a financial markets focus. See what the reactions have been on twitter #hflionsden and watch all six episodes via www.hflionsden.com or www.eurexgroup.com. Enter the Den!

It has been a pleasure bringing to you these topics and more since the inception of Institutional Insights. From everyone at Eurex Group we wish you a very happy festive season and look forward to bringing more interesting and thought-provoking topics to you in 2014.
Thought leadership

Kathryn M. Kaminski

Blending convergence with divergence

Risk is defined as the chance that things do not turn out as you expect. Uncertainty, perhaps even more ominous, is the chance the circumstances, the extent or magnitude of events are unknown to you. As individuals, in both finance and in our personal lives, we are constantly engaged in some form of risk taking. This varies from what we decide to eat for lunch to when to go bearish in equities. Given that risk taking is at the core of human experience, we can take a closer look at the two types of risk taking and how they impact our financial performance and expectations.

Just a few weeks ago, the Nobel Prize in Economic Sciences was awarded to three tremendous contributors in the world of finance. Their contributions represent two approaches which give a fundamentally different view of financial markets.¹ First, the view that financial markets are efficient: a Eugene Fama world. Second, the view that financial markets are made up of people, people who may suffer from “irrational exuberance”: the Robert Shiller world of behavioral finance. Given this dichotomy of perspectives, it is only natural to revisit the basic tenets of risk taking and discuss how these impact our lives and our path towards success in financial markets.

In a seminal article on this topic, Mark Rzepczynski outlined how two very different world views impact the style of risk taking.² The two types of risk taking are divided based on our underlying frame of reference: convergent and divergent. We are convergent risk takers when we believe that the world is well structured, stable and somewhat dependable. We are divergent risk takers when we profess our own ignorance to the true structure of potential risks/benefits.

¹ The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel was given to Eugene Fama, Lars Peter Hansen, and Robert Shiller. To quote the Nobel Prize Selection Committee, “The Laureates have laid the foundation for the current understanding of asset prices. It relies in part on fluctuations in risk and risk attitudes, and in part on behavioral biases and market frictions.” Press Release, The Royal Swedish Academy of Science October 2013.

² Reviews risk taking from the trading perspective: Rzepczynski (1999)
The convergent strategy has many small gains and catastrophic losses and the divergent strategy has many small losses and euphoric wins.

Examples of convergent and divergent risk taking
Imagine two simple strategies: strategy C for convergent and D for divergent. Each strategy is applied to a simple game of chance which is played consecutively over time. If we start with strategy C, each time you win you take your money and start a new subsequent game. When you lose, you keep playing the same game until you win again then start a new game. This game doubles up on losers and takes profit on winners. Strategy C believes in the profits and takes them but reconfirms its conviction by doubling up with losses. A strategy like this will have many small gains with the occasional catastrophic loss. A person who uses a strategy C believes in the system, trusting that in the long run they will win. When they are shown to be incorrect, they simply wait until things get better again to reconfirm their beliefs.

When we turn to strategy D, in this strategy each time you lose you quit, cut your losses and start a new game. When you start to win instead of quitting, you double your bet. This strategy has little faith in positions that are losing and tries to follow the prevailing run when they seem to have found a string of luck. In each particular game, strategy D has little faith in a losing position. Strategy D faces many small losses with the occasional huge win.

When we compare the distributions of convergent strategy C and divergent strategy D, we see that strategy C is comfortable with winning almost expecting things to go as they suppose. Strategy D is rather skeptical taking lots of risks but never investing too much in any particular game. These two approaches are mirror opposite in their outcomes. The convergent strategy has many small gains and catastrophic losses and the divergent strategy has many small losses and euphoric wins. When we make some simple assumptions about the underlying game, the distribution of an example of these two is shown in Figure 1. These two extreme yet simple examples show that convergent strategies have negative skewness and fat left tails while divergent strategies have positive skewness and fat right tails.

Figure 1: an example of strategy C and strategy D in a simple simulation

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<thead>
<tr>
<th>Convergent risk taking</th>
<th>Divergent risk taking</th>
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3 Here we make no assumptions about the distribution of the game, its stationarity in time or other details allowing for generality.
Reflection on convergent, divergent

If you turn to many activities in life, our behavior is based on convergent and divergent risk taking. For example, when you cross the street, you are taking a convergent risk. In most cases, you get to the other side earning a small gain. In the rare catastrophic event that you are run over, the consequences are disastrous. In this example, we tend to believe that crossing the street is generally safe.4 If we turn to social networking as another example, successful social networkers often use divergent risk taking strategies. They talk to as many people as possible quickly and often stealthily cutting their losses with those of less interest. A powerful social networker understands that they never know how many people it could take to hit the key contract persons which lead to new business deals. Social networkers which use convergent risk taking strategies only speak to the people they know and already consider interesting, developing those relationships but creating no new ones. There are many fields where divergent risk taking is the name of the game. Entrepreneurs, venture capitalists, and researchers try lots of different ideas and approaches until they actually find one that is the big winner.5

If we turn to financial risk taking and investment, taking a simple financial example, investment in equities is something that most investors believe in. They believe in both the existence of an equity risk premium over the long run driven by fundamental value and they believe in the efficiency of financial markets. In this framework, “investing” in equity markets is a convergent risk taking activity. In distribution, this is also true. Equity returns are positive in expectation yet negatively skewed with fat left tails. If we turn to divergent risk taking in financial markets, the obvious example is trend following. Trend followers do not believe in anything but opportunity. They profess their ignorance to the fundamental structure of market prices, guessing that on occasion markets may be driven by so called Keynesian “animal spirits” leading to periods of opportunity.

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4 In the U.K., it is particularly important for right looking tourist who crosses traffic without looking taking substantial risks without even considering it.
5 This is a process which Nassim Taleb labels as tinkering. In his new book Antifragility, he discusses how tinkering leads to most important discoveries.
6 In practice most trend following strategies have a 2/3 failure rate of positions. This means that most trades may lose money but the ones that win seem to outweigh the smaller losses over time.
How should we invest? Which risk taking strategies are prudent?
Risk taking and the actions we take in response to risks are directly linked to our belief structure and financial world view. As a result, this may lead us to invest in different things especially across time. This causes us to ask ourselves, what does it mean to invest? What is speculation and what is investment or does this even matter? If we turn to the definition of investment, “An investment is an asset or item that is purchased with the hope that it will appreciate in the future” (Investopedia). If we take a polarized view, thinking that markets are either efficient or irrational, we will only be convergent or divergent in our strategies. Yet during this cold December in Stockholm, the Nobel Prize selection committee sends us a reminder that we need to acknowledge the importance of two very different world views. If both of these views are important, this means that both styles of risk taking are important for success and performance in financial markets.

To make this point more concrete. If markets are efficient, convergent strategies are prudent in assets which maintain a core fundamental structure. For example in this context, long term investment in equities without cutting your losses makes sense. On the other hand, we must also profess our ignorance to the true structure of financial markets yielding to the “animal spirits” of the market. In this case, divergent risk taking strategies that respond well to the unknown and the uncertain. The optimal combination will depend of course on the state of the financial markets and the players who participate in them. The best overall strategy will be to combine some of both risk taking approaches. To summarize, convergent risk taking allows us to compete and maintain value over time while exposing us to hidden risks (the so called black swans) whereas divergent risk taking allows us to adapt, innovate, and hopefully survive during periods of market distress.

References

7 In the previous newsletter, we discussed Andrew Lo’s Adaptive Markets Hypothesis. This view of markets is consistent with both classic views suggesting instead that markets adapt and evolve over time. This framework lends its structure and principles from the field of evolutionary biology. The forces of competition, natural selection, adaptation, and reproduction can be seen to drive the market ecology. These factors combine to determine who will succeed or fail in financial markets. See Lo (2004, 2012).
8 As an example, Chung, Rosenberg, and Tomeo (2004) discuss how to allocate capital using a convergent and divergent approach in hedge fund portfolios. Their article shows, both conceptually and empirically, how this can be done in practice.
9 This article is the subject of a TEDx talk given by the author and available at www.tedx.com.
In the previous edition of Institutional Insights, I discussed equity index futures, specifically Eurex Exchange’s MSCI futures. In this edition, we include the fixed income space with the newest product launch – the introduction of Options on Euro-OAT Futures.

Buy side clients often ask where I see new products coming from. What are the future products of the new generation to come?

This is indeed a very good question and sometimes difficult to answer. I’m a believer that there is always a good case to make for options products. Options offer a diversity of trading opportunities, more so than their underlying and help their users in elaborating multiple case scenarios.

On 10 September 2013 Eurex launched Options on Euro-OAT Futures (OOAT) due to increased demand for the contract following the success of the 10-year Euro-OAT Futures, which today has open interest of nearly 180,000 contracts.

By introducing options contracts on Euro-OAT Futures, we further complement our fixed income products on European government bonds. Along with futures contracts on mid-term and long-term French government bonds (Euro-OAT Futures, Mid-Term Euro-OAT Futures) successfully introduced in 2012 and 2013, an options contract on the existing long-term Euro-OAT Futures contract is now available for the first time.

Buy side clients can benefit from an efficient, liquid and cost-effective instrument which extends hedging and trading opportunities by making the volatility in the long-term maturity range of the French interest rate curve tradable at the exchange.

The Eurex Options on Euro-OAT Futures (OOAT) can also be traded outside the order book on a bilateral basis, and subsequently booked to Eurex Clearing through the use of our EurexOTC Trade Entry services.

Since launch, nearly 16,000 contracts have traded – supported by a group of seven Market Makers providing liquidity during the trading day (08:00 – 16:15 CET).
The combined RDX® options and futures open interest exceeded 480,000 contracts at the end of November 2013. The open interest for RDX® options alone registered 389,000 contracts.

Additionally, buy side participants trade OTC flexible contracts regularly. The total traded contract volume since launch is 1.5 million contracts for RDX® options at the end of November 2013. Average daily volume in 2013 for the options stands at 4,500 contracts.

There is also a significant amount of OTC Block Trades that participants can take to the EurexOTC Trade Entry facility.

Depending on the volatility level of the market and on the growth of the volume of the underlying contract, options contracts are a very useful instrument which helps buy side clients to manage, in a dynamic and cost efficient way, their futures positions.

As you can see, options contracts – whether fixed income or equity derivatives – offer a variety of trading opportunities for buy side entities, which is definitely worth exploring alongside their underlying.

In the coming changing regulatory landscape, which favours more cleared products than uncleared ones, having access to multiple listed products will definitely help you as a buy side to mitigate your risk and to choose between listed or pure OTC products.

So keep an eye on the development of these products. They will definitely help you going forward!

There is also the possibility to do Vola Trades. An OTC Vola Trade is a futures trade delta-hedging an existing options trade on the same underlying instrument. The options can be traded either in the order book or as a block trade (in which case they have to meet the minimum block size).

However, the size of the futures trade is not subject to a minimum block trade size and depends solely on the delta of the options position.

In the listed equity index space, we have recently seen the launch of a new liquid options contract – the RDX® USD Index Options (ORDX), the options contract of our RDX® USD Index Futures based on the Russian Depository Index.

Volume and open interest have grown rapidly since launch in March 2012 (see chart on previous page). Demand from the buy side for a liquid hedging instrument such as Eurex RDX® futures and options continues to grow.
The question that buy side clients ask me the most is: what happens if my Clearing Member goes under? What happens to my collateral and positions?

In a word, what are the rules in the case of a default? What do we do, as a clearing house, to protect the end clients?

This is a crucial topic because, in the new era of OTC clearing, clearing houses still face similar issues, and potentially much bigger issues than Lehman Brothers – with much greater systemic risk implications. It is fair to ask what will happen if I am a buy side client and need, overnight, to find a new Clearing Member – and more importantly what of my collateral and positions?

At Eurex Clearing, we have set up a complete solution to answer this situation.

Firstly, Eurex Clearing conducts position netting and hedges the proprietary positions of the defaulting member. Then, if we look at the lines of defence of the risk waterfall, the collateral and the Clearing Fund contribution of the member in default are utilized.

After the defaulter’s contribution is exhausted, assigned dedicated amount of Eurex Clearing is applied before non-defaulting Clearing Members’ contribution and remaining capital of Eurex Clearing AG.

It has to be noted that during the last major defaults (Lehman Brothers and MF Global), Eurex Clearing did not have to go beyond the collateral of the Clearing Member in default to manage the situation.

One important thing to say is that the Default Management Process (DMP) will differ according to the degree of segregation that the buy side client will have chosen.

In the case of a Clearing Member default, if as a buy side client you are in a net omnibus account, the porting of positions is possible only where all clients agree on the same replacement Clearing Member within one business day of the Clearing Member’s default occurring. (Not necessarily the easiest situation.)

On the other hand, as a buy side client, if you are in a fully segregated account (ICM – Individual Clearing Model), there are three options you can choose from:

1. To receive a final pay out of the cash settlement amount, the liquidation process begins.

2. Immediate re-establishment under new relationship (back-up Clearing Member).

3. To become an interim participant and have the positions and collateral be transferred to a new Clearing Member. The interim period can last up to five business days and can be extended by Eurex Clearing.
What are the legal requirements?

- Sufficient coverage for any margin shortfall.
- Coverage of Clearing Fund contribution for the interim period.

It was important for Eurex Clearing, when we were thinking about the design of the DMP, to have a pragmatic approach. If a Clearing Member defaults, it is going to be very disruptive and being heavy-handed will definitely not be a solution in an already stressed market.

That’s why we took into consideration the fact that the market will be stressed and that we have to help, in our management of the situation, end clients who have just lost one of their Clearing Members.

Equally, the principle behind the DMP is geared towards capital/collateral protection – that’s why our entire model is based upon the physical segregation of collateral and positions and not a value segregation where in the case of a default, you receive as a client a cash equivalent which is the case for some CCPs.

Make sure you ask the right questions regarding the DMP – you want to make sure that any eventuality has been used for the building of the stress testing scenarios.

**Client Asset Protection: key benefits**

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<th>General</th>
<th>Individual Clearing Model</th>
<th>UK CASS compliant Omnibus Model</th>
<th>Elementary Clearing Model</th>
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<td>- Maximum protection for clients under a proven legal construct</td>
<td>- Segregation of client margin collateral mitigating the impact on clients in the event of a Clearing Member’s default</td>
<td>- Net margin call on omnibus account</td>
<td>- Omnibus segregation of client from proprietary positions and collateral</td>
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<td>- Different segregation models to satisfy customers’ needs</td>
<td>- Portability of positions enabling continued trading in the event of their Clearing Member’s default</td>
<td>- Supports segregation of collateral for non-disclosed clients and NCMs under the UK CASS rules</td>
<td>- In order to ensure portability of clients’ positions and collateral for eligible jurisdictions all omnibus clients need to agree to be ported to a single new Clearing Member.</td>
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<tr>
<td>- Compliance with regulatory requirements</td>
<td>- Portability of client margin collateral in the event of a Clearing Member’s default</td>
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In this edition of Eurex Institutional Insights, Renaud Huck, Head of Buy Side Relations at Eurex Group talks to Margie Lindsay, Executive Editor of Hedge Funds Review, about her outsider-insider look at the hedge fund industry, the state of the industry at the moment and what she believes will be the themes going forwards.

Huck: How did you get started in journalism?

Lindsay: I started at a Canadian publishing company for a weekly oil publication. At that point I looked around and said “what’s the best newspaper in the world? The Financial Times – I should be a journalist for the Financial Times.” So I got a job at the Financial Times.

Three months later Gorbachev came to power and the world changed so there was a lot to write about. Except this time it was investment banks. But for the hedge funds, it was an exciting time. It was the beginning of a revolution and an evolution in the hedge fund industry. At the time I didn’t appreciate it that much, but when I started, theoretically, the majority of assets under management by hedge funds came from private individuals, fund of funds, and family offices. Today its 80 to 85 percent institutional investors – so in a very short space of time there’s been this big shift. The fund of funds industry has been decimated in Europe. It’s held together in the U.S., but again, they have had to completely change their models and moved into

Huck: You joined Hedge Funds Review in February of 2008, so a few months later you obviously had a lot to write about. What was it like to be thrown into a new topic, and then have things change so rapidly?

Lindsay: It was a bit like 1989 when every time I came back to the office, another communist country had collapsed. Except this time it was investment banks. But for the hedge funds, it was an exciting time. It was the beginning of a revolution and an evolution in the hedge fund industry. At the time I didn’t appreciate it that much, but when I started, theoretically, the majority of assets under management by hedge funds came from private individuals, fund of funds, and family offices. Today its 80 to 85 percent institutional investors – so in a very short space of time there’s been this big shift. The fund of funds industry has been decimated in Europe. It’s held together in the U.S., but again, they have had to completely change their models and moved into

Huck: So that’s quite a transition then from oil, to financial markets to politics?

Lindsay: Journalists are meant to be good at asking questions and the philosophy – of British journalists at least – is that you’re not an expert on anything because if you are the expert you don’t ask the questions. So the idea is that if you’re good at asking questions and good at writing it doesn’t matter what the subject is you should be able to pick it up without any trouble.
a different way of operating. Because I was completely new to all of this I didn’t find this odd I just found it logical and accepted it whereas someone else might have been thinking or clinging on to an old form and an old idea of what hedge funds should be.

Huck: What was the reason for this move?
Lindsay: The collapse of the banks basically.

Huck: So the internal business model of the prime broker business model changed.
Lindsay: Before “the crisis” the prime brokers used to worry about the hedge funds and whether or not they were a good credit risk. And as soon as the hedge funds started questioning the credit worthiness of their prime brokers the prime brokers didn’t like that.

I remember talking to BNY Mellon quite a few months before the Lehman Brothers incident and they had witnessed billions moving into custodial accounts out of prime brokers. Of course the hedge funds were blamed for collapsing banks because they were pulling assets, but their duty was to their shareholders and their investors – to protect their money. They were the ones that were caught in the chaos and that was a disaster for them. The whole model of how hedge funds operate the relationship with the prime brokers has changed; the relationship with the fund administrators has changed. Relationships with custodians, who previously weren’t visible to hedge funds, also changed.

Huck: Segregation models also, have evolved. Before, there were hardly any segregation models whereas now, hedge funds demand that collateral be protected. The old omnibus account is no longer good enough.

Lindsay: Before the crisis, they were regulated but not formally regulated. You had the FCA and FCC but there wasn’t any overarching regulation. Now you have the AIFM directive, you have Dodd Frank, you have plethora of things that have hit them out of nowhere, and they’re not used to that either. They were treated as though they were the cause of the crisis, when they were actually the solution to the crisis.

Huck: The (then) governor of the IMF, Jack Jesuf, was quite clear that the buy side had nothing to do with the melt-down of the financial system but rather the sell side banks were at fault. The irony being that now everyone is caught in regulation and some may say over-regulation.

Lindsay: In some respects hedge funds have taken up some of the functions of the investment banks. Lending is a good →
example. Very soon after the collapse of Lehman Brothers, one of the first things I noticed was that anybody who needed trade credit financing under USD 50 million couldn’t get anything from the banks. Suddenly 10 to 15 little hedge funds emerged, mainly in Switzerland, to conduct trade finance to help coffee growers, cotton, sugar, and other commodity producers. These people couldn’t get any trade credit from their banks so the hedge funds were filling a gap. Thus, you now have asset backed bank lending and other lending types that weren’t offered before.

Lindsay: One of them. You have the prop desks disappearing from the investment banks; you have hedge funds becoming market makers where they weren’t before and hedge funds becoming members of exchanges which they wouldn’t have considered before. They’re moving into completely different territories, at the same time because their investment bases changed into this institutional framework, investors had already pushed hedge funds into transparency and better operations. The investment community asked for this long before the regulators got there. But now nobody really knows what’s going to be happening next. It’s like we are on the edge of a really big slope.

Huck: Absolutely. The very nature of their investor-base has changed. For example, pension funds require more disclosure, more openness and more transparency. They want to be in a position to have a good reading of the investment vehicle and the investment structure that they invest in.

Lindsay: You need look at it globally too. Investors are far more interested in hedge funds and alternatives and will have 20 percent or more of their portfolio in alternatives in the U.S., most of which will be hedge funds. In the U.K. the proportion is approximately 15 to 20 percent, whereas continental Europe is still scared of hedge funds because they think they’re the evil incarnate. Asian investors are →
approaching U.S. levels in terms of the proportion they allocate to alternatives. All of this with the backdrop of growing regulation around the world.

One of the unintended consequences in the U.S. is the passing of the jobs act which now has lifted the 80 year old ban on general solicitation and advertising for hedge funds so all of a sudden you have all of the U.S. hedge funds going to market and being very open about what they do and how they do it, whereas in Europe it’s still closed, and we are talking about transparency and so what’s wrong with that?

Huck: So there’s a new market opening up in the U.S.?

Lindsay: Yes and no. A great many of the hedge funds I talk to understand their end investor now is actually the guy on the street who invests in pension plans and insurance plans. This is fuelling transparency too though these are still complex financial organisations and hence not easy to understand in the simplest terms. Hence you have to be a qualified investor to invest in them. It doesn’t mean hedge funds are going to commission TV ads and billboards in New York, but they are allowed to be more open about what they can publish about their performance figures which they were never allowed to do.

Huck: I think that by broadening the horizon, normally you introduce a level of competition, but also you introduce a level of diligence and homework that investors have to do. What’s keeping these guys awake at the moment?

Lindsay: For a hedge fund, the thing that’s always kept them awake at night is how to make money. It’s all about performance, that’s the key to everything.

Huck: I think regulation is a big issue that’s keeping them awake. There is no revenue coming from equities. Fixed income yields are at rock bottom, so there is no revenue coming from short dated or long dated paper. Currencies are very volatile, but volatile without any volume and the commodity space is also volatile without significant production. On top of this you have an arsenal of regulation which brings little tangible returns.

Lindsay: And particularly in Europe where they can’t make up their minds what they’re doing – there’s no clarity. The AIFM directive might have come into force but nobody actually knows what it means because there are so many question marks against so many parts of it. Everybody wonders why all the hedge funds are sitting around not doing anything not thinking that they simply don’t know what to do yet until
everything’s clarified. The economies and the markets might be total messes but what’s interesting is that I could probably name 10 hedge funds for every strategy that are performing well.

Huck: What does it mean though for the smaller guys, what does it mean for new entrants?

Lindsay: When you talk to a multibillion dollar hedge fund they will tell you that you never start with billions in assets.

Perhaps you start with a few million or a few hundred million. The difference now is because of the level of institutional money involved and the resulting compliance requirements; you’re expected from day one to have a certain minimum structure for operations. If after 12 to 18 months you’ve only raised USD 100 million it’ll be difficult to survive because of the overheads you have as a small business. And let’s not forget, these are small businesses and not just a guy in a back room trading at a computer.

The industry is very worried that new talent will just wither and die if they don’t have some help so you do have some seeding places. They don’t do as much as everyone else wants them to do but it’s hard. What you are seeing is some of the big houses are bringing in complimentary strategies and people so if they have a good idea, instead of setting up on their own, they might come into a bigger established hedge fund and start that way.

Huck: So the fund has already this infrastructure in place?

Lindsay: Yes it’s not exactly seeding but it’s similar to seeding. Some of the big houses are doing that internally with the guys inside the big houses spitting out to do their own strategies as well.

Don’t forget that most invest almost all of their personal wealth in these funds, and it’s not just on the performance side, they’re putting it in as working capital to make sure they have the right kind of infrastructure and the right kind of staff before they can get to the next level. But it is very tough so for these guys, the worst thing that could happen is regulation and compliance that stops the industry fostering new talent.

Huck: What is the industry doing to help itself?

Lindsay: Very little. It’s a collection of individuals that don’t really work well together. There’s no real mechanism to do that but you have some big seeders such as Blackstone, Goldman Sachs and Man Group. Basically if you have the will to do it, the correct strategy that’s coherent and explainable, you should be able to succeed. But you have to have a lot of start-up capital to start doing it. It’s the same attrition rate that you get for small businesses, probably about 10 to 15 percent fail, and I think the difference pre-crisis to post-crisis is that before it took longer to fail now it’s pretty obvious within 12 to 24 months whether you’ll succeed or not.
And you get caught in a catch 22 situation where the institutional investors aren’t interested unless you have a 12 month, 18 month, 24 month track record, but you can only do that if you are able to do the marketing for the fund to raise the assets you need which required the infrastructure to be in place.

Huck: So it’s a matter of surviving the first 12, 18 and 24 months?

Lindsay: Exactly. Institutional investors are beginning to understand this catch 22 situation faced by niche emerging managers. They understand that on day-one you’re not going to have the operational infrastructure in place because you can’t afford it yet. But if you can show them a plan of how you’ll grow and put this infrastructure in place it goes a long way to comfort them into investing in you. We’re seeing funded administrators and prime brokers offering services to emerging managers because they are the ones that are going to be the black stones in the bridge waters of the future – so it’s a good investment.

Huck: That’s where Hedge Fund Lions’ Den comes into the picture. Can you explain the premise behind the show, why you’re doing it and what you hope to achieve?

Lindsay: Together with Eurex Group, we wanted to produce programming in a very personal way to show what some of these problems really are. These guys are not just passionate about what they do but are really committed and good business people who are up against really tough problems. What they (and viewers) can do is learn huge amounts from some of the biggest names in the business who have taken funds from zero to billions of dollars. The show answers the question of how you make yourself into a sustainable hedge fund and we thought doing that through a reality TV programme would be much more fun, and much more instructive to the industry as well as to investors.

Huck: It’s the crystal ball question now. Based on the last couple of years, what will be the big themes in 2014 and 2015?

Lindsay: As far as the hedge funds are concerned, it’s still going to be performance, they need to get that performance up and actually even if you pick the right fund and you have the performance, it’s still a very tough environment for them to work in. You don’t know what the Fed is going to do, you don’t know what other central banks are going to do next and I think they’re coping really well.

It’s also going to be about getting regulation under control. U.S. regulators are becoming a bit impatient to see that EMIR is not making a lot of progress.
“I think by the end of next year most likely ESMA will give clearer signals about the regulation and during 2015 we will see more enforcement of asset classes being regulated.”

because ESMA is teetering. I think by the end of next year most likely ESMA will give clearer signals about the regulation and during 2015 we will see more enforcement of asset classes being regulated.

It will of course have an impact on the buy side but I think it will have a positive impact. What makes this industry of interest is the story behind the investment strategy. A good story capturing investment and capturing returns at a time when there aren’t many big events such as elections means the very nature of the quality of the portfolio manager that makes the difference.

I really think you’re going to see a lot more money flowing into hedge funds and I think gradually a lot more of that money is going to be flowing into the smaller hedge funds rather than the big guys which is what’s happening now.

Huck: Why?
Lindsay: Because the larger hedge funds are getting very close to capacity or have hit capacity. Smaller managers can be much more nimble, and usually are not necessarily taking more risks but because of their size they can take more profit so you get a higher performance figure from them. →

The opinions in this interview are those of Margie Lindsay and do not necessarily reflect the opinion of Hedge Funds Review.